PSAB/Asset Management

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GOVERNMENT FINANCIAL REPORTING - CONCEPTS AND OBJECTIVES

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And now for something completely different …..

In the first newsletters, we looked at many issues and topics relating to the development and valuation of your tangible capital asset inventories. In the last ten newsletters, we discussed various issues relating to budgeting and accrual accounting and tangible capital asset accounting. We now turn to the final result of all this effort, the financial statements that you will be preparing in the new accounting environment.

This newsletter will look at the background to what is happening, which is given in Sections PS1000 and PS1100 of the Public Sector Accounting Board Handbook, and the concept of "generally accepted accounting principles", or GAAP. Future newsletters will look at each of the four principal statements that you will have to prepare as part of your financials, and the key messages that each is intended to communicate. We will take a special look at the concept of "municipal surplus", or the net economic resources available to use in providing future services of a municipality, and at the notes to the statements. This will be done by comparing a municipal financial report prepared in the traditional format with the same financial report prepared in accordance with Section PS 1200. We will conclude the series with a look at several topics related to financial statement presentation.

The Financial Reporting Model for Governments

Before we can look at the details of what should be included in financial statements, and of how the implementation of full accrual accounting changes of your statement presentation, let us first look at the financial reporting model which governments are expected to follow. This comprises the rules, parameters and content requirements that govern financial statement presentation.

"At a minimum, a financial reporting model prescribes the number, type and format of the financial statements, what information those financial statements should report, when it should be reported and how, as well as the notes required to explain what has been reported in the financial statements.

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A financial reporting model dictates the basis of accounting in compiling a government's accounting records because the accounting system must be able to generate the financial information needed to meet the requirements of the model. The basis of the accounting is the prescribed method of accounting, such as cash or accrual, that specifies when revenues, expenses, assets and liabilities should be recognized in the financial statements.

"The new reporting model prescribes five indicators or "messages" that should be included in government financial statements: net debt; accumulated surplus/deficit; annual surplus/deficit; change in net debt in the year; and the cash position and the cash flow in the year. Each is needed to help readers understand how well a government has managed its finances in a year and where it stands in terms of resources held and debts owed at the end of that year. The new model also prescribes the full accrual basis of accounting, which means that it incorporates information about the stock and use of a government's capital assets". (i.e.tangible capital asset accounting)

> from "*20 Questions about Government Financial Reporting",* published by CICA/PSAB, page 10.. Note that while originally written for federal, provincial and territoritial governments in 2003, this model now (2009) applies to all Canadian public and non-profit sector organizations.

We will look at the financial statements in terms of how they support the new reporting model, and of meeting the needs of readers in today's changed political and financial environments.

The Context

PS 1000.07 states *"A government financial report should present information that is useful in evaluating the government's financial condition at the end of the accounting period and its financial performance during the accounting period. Government financial statements are a fundamental component of a government financial report."*

In short, the financial statements comprise a report card on the operations of a government during an accounting period for users and interested parties – your Council, your residents, your staff, other governments, the media, banks, investment houses, credit rating agencies, etc.. This has not changed. Municipal financial reporting in Canada and has always met the above requirement. What has changed are the concerns of readers and users of the statements, and perhaps rising expectancies and rising requirements for greater transparency.

Qualitative Characteristics

PS 1000.24 states *"Financial statements should communicate information that is relevant to the needs of those for whom the statements are prepared, reliable, comparable, understandable and clearly presented in a manner that maximizes its usefulness".*

The five characteristics identified have not changed and probably never will. However, what has and does change are users expectations and needs, and how they may want to use a set of financial statements. Reporting on tangible capital assets owned and controlled was not deemed to be relevant 100 years ago, whereas now there is interest in this in many jurisdictions around the world. While debt instruments (T-bills, bonds, debentures, etc.) outstanding were seen to be a good indicator of the financial viability of a government jurisdiction, the thinking now is that the net book value of tangible capital assets is also an important component of the financial position of a government, as these are available to provide future goods and services, instead of having to contract for them. Because governments budget and set taxation rates on a taxation year basis, the focus has traditionally been on financing requirements and disbursements on a taxation year basis. The current massive financial stimulus packages being implemented in various jurisdictions are examples of moving beyond a taxation year focus and planning.

Sub-section PS 1000.32 acknowledges that there may be trade-offs, such as between relevance and reliability, or between the accountability value of information and the level of detail appropriate to the financial statements, as well as the cost of providing it. We encountered examples of this in developing the asset inventories. Capitalization thresholds are an example of where the level of detail was reduced substantially, in a way that did not significantly impact on the relevance and reliability of the resulting data being presented.

While the scope and breadth of relevancy may change over time, reliability, comparability, comprehensibility, and clarity of presentation are and will be on-going and timeless requirements.

Recognition and Measurement

Recognition means inclusion of an item within one or more individual statements, and does not mean disclosure in the notes to the financial statements (PS 1000.53).

PS 1000.55: *"The recognition criteria are as follows:*

(a) the item has an appropriate basis of measurement, and a reasonable estimate can be made of the amount involved; and
(b) for an item that involves obtaining or giving up future economic benefits, it is expected that such benefits will be obtained or given up."

With respect to tangible capital assets, they have always been recognized, but as an expense. Changed user needs and expectations now call for them to be recognized in a different way, as the acquisition of an asset that will provide benefits over a number of future accounting periods, rather than just as an expense in the period of acquisition or payment.

Measurement is more straightforward. Historical cost has always been the preferred basis, because it is verifiable, can be documented and audited, and is objective. Other bases are permissible in certain limited circumstances, such as where historical cost is not available or determinable, such as for older TCAs. Nominal value (=CAD 1.00) is an example of this.

Financial Statement Objectives

Section PS 1100 gives four objectives of financial reporting:

#1 - (PS 1100.16) "*Financial statements should provide an accounting of the full nature and extent of the financial affairs and resources which the government controls, including those related to the activities of its agencies and enterprises"*

#2 – (PS 1100.20) *"Financial statements should present information to describe the government's financial position at the end of the accounting period. Such information should be useful in evaluating:*

(a) the government's ability to finance its activities and to meet its liabilities and contractual obligations; and
(b) the government's ability to provide future services."

#3 – (PS 1100.36) *"Financial statements should present information to describe the changes in a government's financial position in the accounting period. Such information should be useful in evaluating:*

(a) the sources, allocation and consumption of the government's recognized economic resources in the accounting period;
(b) *how the activities of the accounting period have affected the net debt of the government; and*
(c) *how the government financed its activities in the accounting period and how it met its cash requirements."*

#4 (PS 1100.61) *"Financial statements should demonstrate the accountability of a government for the resources, obligations and financial affairs for which it is responsible by providing information useful in:*
(a) evaluating the financial results of the government's management of its resources, obligations and financial affairs in the accounting period; and
(b) assessing whether resources were administered by the government in accordance with the limits established by the appropriate legislative authorities."

These objectives would have been as valid and applicable 100 years ago, just as they apply and are valid today and tomorrow. What has changed is the complexity of government, and the scope and nature of government operations and interests. As a result, financial reporting has to be enhanced to reflect these changes, and the differing needs and expectations of users of government financial information over time.

Because government is largely financed through taxation, which is levied on the basis of annual rates, the traditional time horizon has typically been the taxation year, with budgeting, financial management, accounting and financial reporting being on the basis of the taxation year. In short, the focus was the ability of the government to be able to afford and to pay for the expenditures that would arise or would be contracted within the taxation year.

As discussed in earlier newsletters, this current year orientation ignores the realities of capital investments and the acquisition of tangible capital assets. You may spend the money today, but the assets will provide a service stream that may extend over many years, a benefit that traditional government accounting did not take into account. Conversely, the acquisition of a tangible capital asset now may result in additional operating expenditures that will not show up until after the asset has gone into service, perhaps several years from now. The financial reporting changes that municipalities must implement no later than January 1, 2009, are designed to overcome these shortcomings, as well as report on the value of the TCAs controlled by a government.

The Unique Characteristics of Government

Appendix A of PS 1100 discusses the unique characteristics of government, as opposed to the private sector, and what the reporting implications are. These characteristics are:

1. *Government's goal is to provide services and redistribute resources, not make a profit;*
2. *Most government's tangible capital assets are different in nature than those held by a business;* (they represent service capacity, rather than potential for income generation)
3. *Government capital spending may not focus on maximizing financial return because government objectives are broader;*
4. *The principal source of revenue for government is taxation;*
5. *Senior governments hold assets acquired in right of the Crown;* (does not apply to municipalities in Canada)
6. *Governments operate in a non-competitive environment;* (usually!)
7. *A government's budget portrays public policy, establishes estimates of revenue, expenditure and financing requirements and is an important part of the government accountability cycle;*
8. *Some governments have debt capacities unparalleled by most other organizations in Canada; and* (does not really apply to municipalities)
9. *Governments are held to a higher standard of accountability than a business or a not-for-profit organization.*

As a result, governments do not report "net equity". The difference between total assets (financial and non-financial) and total liabilities will be reported as "accumulated surplus", or deficit, as the case may be. Since a taxpayer would prefer every jurisdiction to be a truly non-profit operation, collecting no more than its cash requirements, any difference is clearly a surplus or deficit that could theoretically be distributed or collected in future taxation periods. We will look at this "surplus" further in a separate newsletter.

Most think of "debt" as the bonds, debentures or other commercial paper issued by a government. Debt instruments outstanding are a key concern, as debt repayments will have first claim on all revenues raised in a taxation year. Debt outstanding will also have an impact on the ability of the government to issue additional debt for new capital spending, if desired or required.

However, for financial reporting, net debt is more than just the bonds and debentures issued. It is the difference for a municipality between financial assets, or the economic resources that can be used to meet obligations as they come due or to finance future goods and services, and total liabilities including amounts it owes to external parties, including government employees (accounts payable, issued gross debt, employee pension and other retirement obligations, employee future benefits, landfill closure and post closure care, etc.). Net debt, as reported in the financial statements, may be considered by bond raters and other users in determining the credit worthiness of a government, impacting the cost of capital or credit terms. However, at the local government level the ability to issue debentures is generally based on debt capacity and debt service to revenues, not on the difference between financial assets and liabilities.

The last characteristic, a higher standard of accountability, is particularly true for municipalities, where councilors are local residents and members of the community, and are traditionally much more accessible to the individual taxpayer and to the media than is the case for members of more senior levels of government.

Generally Accepted Accounting Principles (GAAP)

PS 1150.04 states *"A public sector reporting entity should apply every primary source of GAAP that deals with the accounting and reporting in financial statements of transactions or events encountered by the public sector reporting entity."* The previous subsection (PS 1150.03(c)) identifies primary sources as the standards in Sections PS1200 to PS3800 and the Public Sector Guidelines.

From "*20 Questions about Government Financial Reporting",* published by CICA/PSAB, page 14:

"For financial statements to be credible, readers need to have confidence that the statements follow accepted and identifiable standards established by an arm's length standard-setting body. Standards should not be chosen according to the preferences of individual financial statement preparers or auditors. Accounting principles that are subject to either changes in laws or the needs of special interest groups result in inconsistencies in both the principles and their application….Further, bias can occur when accounting principles are selected with the interest of a particular user, economic or political objective(s) in mind.

"….. If individual governments of the day follow independently set standards, readers can have confidence that the financial statements are consistent or comparable over time. Without such confidence, the credibility of all government financial statements is compromised."

This epitomizes why we adhere to a standard financial reporting model developed by an independent standards-setting group, the Public Sector Accounting Board (PSAB) of the Canadian Institute of Chartered Accountants (CICA). The ability of readers to compare governments in different jurisdictions is thus considerably enhanced.

And it should be noted that PSAB's processes for developing standards do provide ample opportunity to express individual points of view.

Summary

This has been a very high level look at the concepts, objectives and characteristics of government financial reporting, and of some of the reporting changes that will be required, starting with fiscal 2009. To get the whole story, you are encouraged to read the respective sections of the Public Sector Accounting Handbook. "*20 Questions about Government Financial Reporting",* published by CICA/PSAB, and available at www.cica.ca as a "non-authoritative document" is an excellent background document on government financial reporting.

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Our next newsletter will look at the first financial statement, The Consolidated Statement of Financial Position, or the Balance Sheet for the municipality.

For more information and resources regarding tangible capital asset management, go to PSAB/Asset Management or contact:

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